REAL ESTATE AS SECURITY FOR LOANS

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Fifty years ago real estate was the principal security for a loan of money. At the present time, however, personal property has assumed such proportions that the value of real estate as security for loans is questioned by many large investors. Many corporations pay larger dividends on their stock and as large or a larger interest on their bonds than can be obtained from a loan on real estate security. Such a loan, however, has still the great advantage that the lender is able to see his security at the time he makes his loan, and go to see it as frequently thereafter as he may desire.

This distinct advantage that a real estate loan has over other security is, however, somewhat offset in the matter of convenience. The holder of a mortgage frequently has difficulty in securing the interest, and while his remedy by proceeding to foreclose is clear, investors as a rule prefer to receive the interest on their investment and not enforce any penalty for non-payment. Mortgage interest is rarely paid without a bill having been first presented, and frequently this bill must be presented a second or even a third time before payment is made. It is, therefore, less convenient than a bond, which may be registered and the interest sent by check to the registered holder, or stock on which the dividends are now usually also paid by check.

There are, however, several reasons why an investor might prefer a mortgage. First, because his investment is separate and apart from that of others; and, secondly, because it is absolutely within his own control. Unless he is a director of the corporation of which he holds either stock or bonds, it is impossible that he should have full information as to the condition of the company, its prospects and its management. It may be doing a most profitable business to-day and may be losing money next year. A change

in policy may result either in a large increase in net earnings or a large decrease thereof. Therefore many an investor prefers to make his own investment and have as security therefor a separate piece of property, of which at the worst he feels assured that he will become the actual owner; whereas the holder of a bond of a corporation is, in case of default, subject to the wishes of other bondholders and is compelled to act through a trustee. He may find the entire property swept away by a proceeding on a prior encumbrance, and this is all the more true of the holder of stock, who is entitled only to what is left after all the indebtedness is paid.

Method of Making Loans on Real Estate.

The usual method of borrowing money on real estate security is by bond and mortgage, in which case the borrower gives his bond in a sum usually double the amount of the money that he has borrowed, which bond is conditioned upon the repayment by him of the amount borrowed, with interest, at the time stated and also contains certain other conditions which vary with the instrument, these conditions usually being that he will pay the taxes upon the property and produce the receipts therefor each year; that he will keep the property insured against fire for the benefit of the mortgagee, and that if default is made in any of the conditions contained in the bond the principal debt shall, at the option of the lender, become due and immediately payable. Another provision, usually included, provides for an attorney's commission for collection in case proceedings are had thereon. Attached to the bond is a warrant of attorney authorizing the entry of judgment against the borrower. This bond is then secured by a conveyance of the borrower's real estate to the lender, with a condition known in law as a defeasance, whereby it is provided that in case the borrower shall comply with the conditions of the bond, then the indenture or mortgage and the estate thereby granted shall cease, determine and become void. The bond may be given by the owner of the property or by any other person. It should not be forgotten, however, that the bond is the debt and the mortgage is simply the security for its repayment. Therefore it is material to the lender to know who the bondsman is. If he is a responsible person, the mortgage is rendered that much more desirable, as in addition to the security afforded by the mortgage, there

is the express obligation of the borrower to pay the money, together with a warrant of attorney which makes it possible at any time, even though default has not been made, to enter up the bond and thereby secure a lien upon all the other real estate of the obligor. It is not customary to enter the bond accompanying a mortgage in the absence of default, but the right to enter it at any time is unquestioned. Execution, however, cannot issue upon the bond until default is made, which may be either in the payment of the interest, when due, the payment of the principal, when due, or the failure to produce the tax receipts, or to comply with any other of the conditions therein expressed. If the default is in the non-payment of the interest as it becomes due, the bond and mortgage, as a rule, expressly provide that default shall continue for the space of thirty days after the interest becomes due before the mortgagee can exercise his option in declaring the principal sum due and proceed to collect.

Among other methods of lending money on real estate security the following may be mentioned:

1. It sometimes occurs that a borrower owns a mortgage on which he desires to borrow a certain sum of money, but does not wish to sell the mortgage, either because his necessities are less than the amount of the mortgage, or because he wishes to repay his own loan at an early date and thus have returned to him his investment. In lending money by this method, the bond and mortgage should be absolutely assigned to the lender and not conditionally assigned, as a conditional assignment might render subsequent sale of the bond and mortgage difficult. It is the duty of the lender in this case, if the loan is not repaid or the interest not paid as it becomes due, or any other default made, to first sell at public sale the bond and mortgage which had been assigned to him as collateral, just as he would sell any other collateral which he held as security. It is, therefore, advisable to take a collateral note from the borrower with the usual provisions that the lender can purchase at this sale, so that he may thus become the owner of the bond and mortgage and proceed to collect his debt in that way.

2. Money is sometimes loaned on a conveyance by the borrower of his real estate to the lender, with a collateral agreement setting forth the fact of the loan and the conditions of repayment, etc. The collateral agreement accompanying the deed would vary with the particular conditions of the loan, and might be misinterpreted

by the parties thereto after its execution. For that reason, at least, this method of lending money appears to me to be undesirable.

3. It is quite common in certain sections of Pennsylvania to lend money on security of a judgment note, which is entered as against the property of the borrower, either restricted in lien or applying generally to all his real estate. This method of lending money is rarely adopted in Philadelphia, or I presume in any large city. It has the distinct objection of requiring the renewal whenever the lien expires. The failure to secure such renewal in time means a loss of the lien on the defendant's property. It is probably adopted in country districts to save expense, but it certainly is not a form of investment that would recommend itself to a careful investor.

4. The ground rent is not a loan of money on real estate security, but is, as you are no doubt aware, an interest in the property. The owner of a ground rent is entitled to receive a certain fixed rent, payable usually in semi-annual payments, and the person who owns the real estate out of which the rent issues, is entitled to possession and all the other incidents of ownership so long as he pays the rent. In character it so closely resembles a loan of money that perhaps a few words on this subject are not amiss. The rent is usually on a basis of 6 per cent. on the amount of the principal, upon the payment of which principal sum the rent can be extinguished. That is, if the rent can be extinguished on the payment of $1,000, the annual rent is usually $60, which is larger than the ordinary rate at which mortgage loans are made in Philadelphia, where the interest is usually from 4 to 5 per cent. It has the further advantage that it is not subject to the four mill tax levied by the State of Pennsylvania on personal property. From the standpoint of the investor ground rents have disadvantages in that the owner of the rent can not demand that it be extinguished, while the owner of the property may extinguish it at any time that he sees fit unless the rent is by its terms irredeemable and created prior to the acts of April 22, 1850, and June 24, 1885, prohibiting irredeemable ground rents. As a result the owner of the rent is often forced to see the property depreciate, and yet in the absence of waste has no remedy so long as the rent is paid.

In like manner, taxes levied against the property may remain unpaid. These taxes take priority of all other indebtedness, and therefore by so much is the value of the security diminished to the

holder of the rent. On the other hand, the owner of the rent has the advantage of a speedy means of collection by warrant of distress, as any other rent could be collected, and he can also bring suit for the rent due and sell the property. The suit, however, is for the rent due and not for the amount of the principal sum, and the purchaser at the sheriff's sale buys the property subject to the ground rent. The absence of the right on the part of the owner of the ground rent to demand payment of the principal of his rent is the decided objection to this character of investment. His remedy is to sell his rent just as he would sell the real estate if he owned it, usually receiving less than the principal of his investment, if it is a redeemable ground rent. The bidder at the sale almost invariably deducts the cost of the conveyancing, since he does not know how long he can keep his investment.

Assuming that you have determined upon the form of your investment, as to whether it should be on a mortgage, judgment, etc., there are certain other considerations relative to the security for the loan requiring attention.

In lending money a greater equity or difference between the value of the property and the amount of the loan should be required in unimproved than in improved real estate. If compelled to buy in unimproved real estate at a foreclosure sale, its unproductiveness might increase the difficulty of finding a ready market for it. If the lender has no money to improve it, and particularly if he does not have the means to pay the taxes, municipal claims and other charges that may arise in connection with its ownership, he may be compelled to sell it for much less than what would be considered its real value. The value of unimproved real estate is always less certain than the value of improved real estate. The value of all real estate fluctuates and depends upon the demand. In times of expansion, when people are engaging in new or larger business enterprises, builders are also building houses and new factories and other plants are being established, which create a demand for unimproved real estate and such property, desirably located, might be more readily sold than one that has an improvement upon it, which might not suit the requirements of the intending purchaser. But in times of depression, and those are the times when the lender is most usually required to purchase the mortgaged property at a foreclosure sale, fewer buildings are started and consequently there is a smaller demand.

The amount of this equity to be required in any real estate

would vary, of course, with the real estate in question. If in an improving neighborhood, more may safely be lent than if the neighborhood is stationary and largely more than if it is declining. In fact a loan on a property in a declining neighborhood is always of an uncertain character. A loan of from 60 to 70 per cent. of the present selling value of an improved piece of real estate is usually considered a conservative loan, while the loan of 50 per cent. of the present selling value of an unimproved piece of property is perhaps as large as should be made.

In making a loan secured by real estate, the lender should visit the property upon which he is lending the money, in addition to obtaining the opinion of any expert that he may employ to guide him in making the investment. The character of the improvement of the property, whether it is a dwelling house or a business property, whether it stands alone or is one of a row of buildings, whether it is in good condition and also whether the remaining properties in the same neighborhood are kept in good condition; if it is a dwelling house, whether it is in a neighborhood suited to dwelling houses, whether it is in a neighborhood of residences of a substantial character, or in a neighborhood occupied by employees of factories are all matters to be given careful consideration.

One tenant may lease and use together a number of different properties, and the owners thereof may desire to borrow money on the property separately owned by them. Such a mortgage should require a special equity, as there is, in addition to the ordinary risk, a risk of the tenant's business. If he should fail, it might be difficult to find some one who would continue his business, and a severance of the respective properties might render each one much less valuable than all were when considered together and occupied by one person, while the cost of replacing any party walls which had been removed would add considerably to the cost of each separate property.

A large mortgage, $100,000 or $500,000, has certain desirable qualities. As a rule, the interest is paid promptly on the day it is due, whereas the borrower of a small sum of money is very apt to be negligent in his payments. It has the advantage also of requiring you to look to but one person for the interest on a considerable sum of money; whereas if you take small mortgages, you may have to collect the interest on $100,000 from one hundred different people,

which is troublesome and requires considerable book-keeping. It is not to be forgotten, however, that the large mortgage has the objection of having a limited market, and therefore unless you yourself are able to buy in the property at a sale and also able to retain the loan for an indefinite period, the investment might prove very disastrous. What is and what is not a large mortgage depends, of course, upon the community. In a small town a mortgage of $10,000 might be considered large; whereas in a large city, a mortgage for $1,000,000 might not be considered objectionable from this point of view. The point to be remembered is that there are many more people able to invest a small sum of money than there are to invest a large sum, and in times of money stringency the owner of a heavy mortgage might not realize at a sale anything like the proportionate amount that could readily be obtained for one of smaller size.

A property occupied by the owner is usually a more desirable security for a mortgage than one occupied by a tenant. In the majority of instances the property is kept in better condition by the owner whose pride has been known to lead to many sacrifices before permitting his home to be sold under a foreclosure of mortgage.

Small properties will depreciate more rapidly relatively to their value than larger ones. A mortgage of $1,000 on a property renting for $15 or $16 per month might be very well secured when the mortgage was taken, but a few years' neglect of such a property will depreciate its value several hundred dollars, which is a large relative decrease.

As the laws of the different states vary, it is wiser to confine one's loans to one's own state, or to the states with whose laws on this subject the lender is familiar. About fifteen years ago, a number of acts were passed by the legislatures of some of the western states imposing heavy penalties for failure to pay taxes, extending the time during which the owner of a property could remain in possession after a mortgage thereon had been foreclosed, and otherwise attempting to preserve the interest of the resident of the state as against the claim of the non-resident creditor. There have been cases of loans which were supposed to be well secured, where the owner has lost the entire amount of his investment by reason of these provisions, and where he knew nothing of the laws in question until he came to bring his foreclosure proceedings.

The duration of a loan should vary with each particular case. In an improving neighborhood, money for a period of five years, or even longer, may be safe; whereas if the neighborhood is not improving, a longer period than one or three years is not advisable.

In Philadelphia it is not the practice of borrowers to pay their mortgages when the principal becomes due. On the contrary, they are very apt to allow the mortgage to remain until they find it convenient to pay it off, or until they are requested so to do. The lender should, therefore, make a note of the expiration of the loan for the purpose of revisiting the property at the time and determining the question of the advisability of requesting payment of the principal or of continuing the loan. If he concludes to continue the loan, it would be wise to make some memorandum as to the period when he thinks he should again examine the property, and again determine the question of continuing the loan or requesting payment.

The security should be a first lien on the borrower's property. A prior encumbrance is always to be avoided. The fact that it is small relatively to the value of the property is immaterial, because the owner might default in payments due under the prior lien, and a foreclosure might follow and the property be sold by the sheriff without knowledge of the junior creditor and the lien of his encumbrance be discharged. That, however, could not be the case if he had the first mortgage. It would be the case, however, if he had simply a judgment. In that case, if he owns the first lien, he is entitled to priority of payment, but his lien is discharged by the sheriff's sale. In Philadelphia it is now almost the universal practice to secure a policy of title insurance from a title insurance company. In other sections of the state, perhaps this means of making sure that the lender has a first lien may not be feasible. He will then be compelled to rely on the examination by counsel and their opinion. He would be very unwise if he would not thus secure his investment, because it is always the privilege of the person borrowing the money to pay the expenses, which includes the examination as to the title.

The lender should receive a fire insurance policy for a proper amount, and to make sure that it would be wise for him in valuing the property to value the ground and the improvement separately. Insurance companies insist that the owner should carry insurance to 80 per cent. of the value, and the lender is a co-insurer with them to the extent of the deficiency between the amount of his insurance

and that 80 per cent. Therefore it is desirable that he should have a policy of approximately 80 per cent. of the value of the improvement. If possible, he should secure perpetual insurance to avoid the necessity of noting the expiration of the policy and seeing to its renewal. If he has to accept time policies, he should adopt some method of directing his attention to the fact that the policies expire and see that they are duly renewed.

All mortgages in Pennsylvania contain a provision requiring the owner to produce receipts for the taxes levied against his property. The lender should see that this is strictly enforced. Even in Philadelphia, notwithstanding the laws to enable the city authorities to enforce the payment of taxes, I have known mortgages to be foreclosed and to find that the owner had allowed as much as ten years' taxes to remain unpaid. True, he is personally liable for the tax, but if he is insolvent, this liability on his part is not a very great comfort to the lender of money when he finds the sheriff deducts the amount of these taxes before making any distribution of the proceeds of the sheriff's sale. If the property is in an unimproved neighborhood, the lender also runs the risk of municipal claims for sewer, water pipe and other improvements, which no doubt are intended to, and in all probability eventually do, improve the value of his property, but may occasion him a present outlay which might be inconvenient.

The conclusions of the foregoing discussion may be summarized as follows:

(1) While a loan of money secured upon real estate may be less convenient than a corporation bond or stock, it usually pays a little larger rate of interest than the best bonds, is a lien on a specific piece of property and entirely under the lender's control, and its value does not fluctuate with the business or policy of a corporation.

(2) In lending money on real estate security, lend on a bond and mortgage. It is the most usual method, the rights of the parties are clearly established and you secure a lien which continues indefinitely.

(3) Unless you are competent to form an opinion on the value of the property, secure the opinion of an experienced real estate man. In any case, visit the property yourself at the time of making the loan and write out your impressions concerning it. Note the

character of the improvement whether generally useful or only for special purposes, and note the character of the neighborhood. Visit it again when the loan matures and determine whether to continue it or not.

(4) See that you have sufficient equity. Do not lend more than 60 or 70 per cent. of the value of improved property. If the property is unimproved, do not lend more than about 50 per cent. If the property is not in an improving neighborhood, require even a larger equity or decline the loan.

(5) Do not make loans in large amounts. The market for a large loan is relatively smaller than for a small one. In times of financial difficulty, it might be difficult to sell your mortgage or realize upon it a sufficient sum for your needs.

(6) Do not lend money on mortgage in states where you are unfamiliar with the laws and customs.

(7) Lend only on first mortgage. See that you receive a title insurance policy; also a fire insurance policy for 80 per cent. of the value of the improvements on the property. If possible, have perpetual fire insurance. If compelled to take term insurance, be carefut to note the expiration and see that the policies are duly renewed.

(8) Enforce the provision in your mortgage requiring the owner to produce the receipts for taxes levied against the property.